

Improving Your Farm Lease Contract

A guide to help you better understand the business of farmland leases

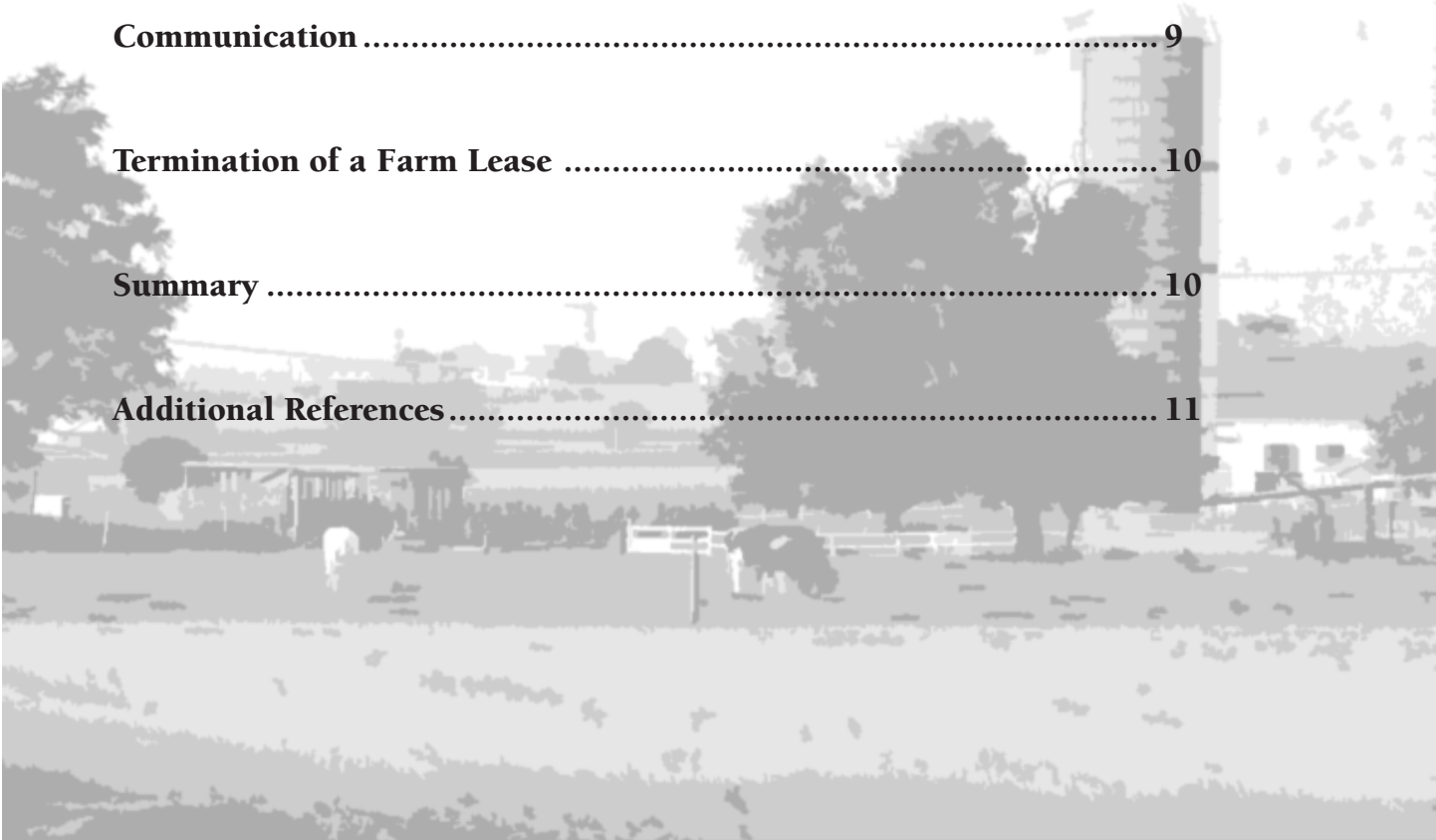


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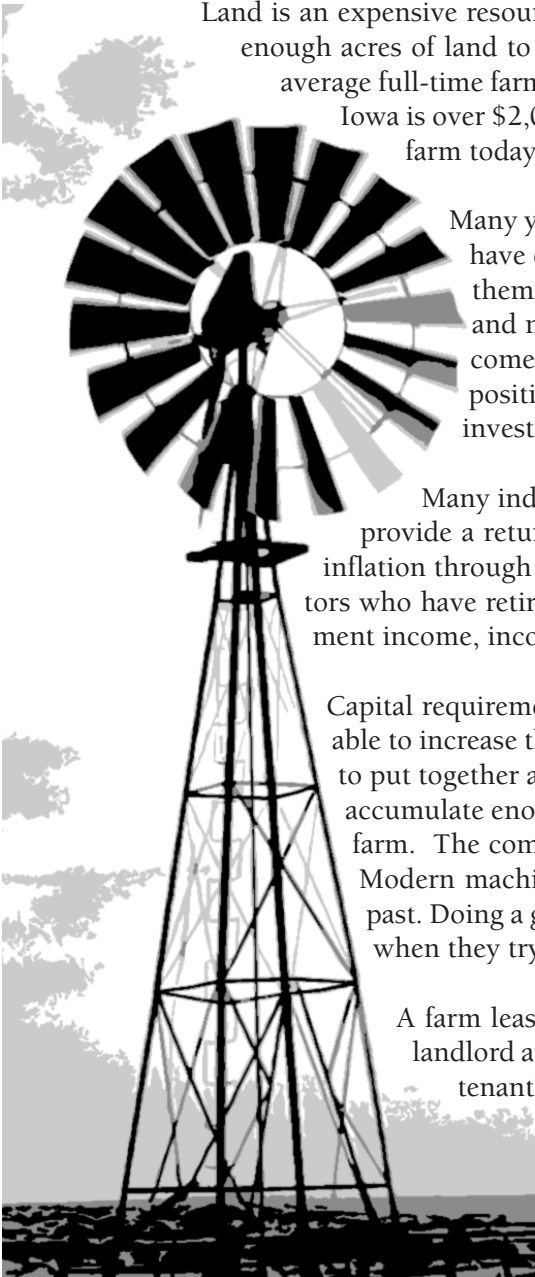


Importance of Leasing

Over one-half of Iowa's farmland is rented and operated by someone other than the owner. In parts of central, north central, and northwest Iowa, two-thirds of the land is tenant operated. On the other hand, less than one-half of the land in southern Iowa is farmed by a tenant.

Leasing farmland involves a business agreement between the owner and the tenant operator who rents the land. Variations in leasing arrangements appear because of the differences in the productive capacity of the resources, the contributions made by each party, and the personal goals of the parties involved.

Reasons for Farm Leases



Land is an expensive resource in all areas of Iowa. A large capital investment is required to purchase enough acres of land to provide the farm family an opportunity to earn a satisfactory living. The average full-time farmer in Iowa today operates over 750 acres. The average value of farmland in Iowa is over \$2,000 per acre. Therefore, the average land investment for a commercial Iowa farm today can easily exceed \$1.5 million.

Many young farm families cannot afford to purchase farmland because they do not have enough capital for a down payment, or the finance charges are too high for them to meet the payments. These families have labor, some operating capital, and management ability that they wish to use in a farm business to produce income for living and future investment or debt reduction. If they are not in a position to purchase land, they can rent land and provide the owner a return on investment.

Many individuals or institutions that own land are looking for someone to farm it to provide a return on their investment. Land ownership can also provide a hedge against inflation through appreciation in value over time. Many landowners are former farm operators who have retired and who wish to retain their investment in the land for security, retirement income, income tax deferral, and sentimental reasons.

Capital requirements per farm unit have been increasing faster than many farm families are able to increase their net worth. Therefore, renting resources may be the only way they have to put together an efficiently-sized operation. Most families desire to increase earnings and accumulate enough net worth so that in the future they can own part or all of the land they farm. The common trend in Iowa is to operate a combination of owned and rented land. Modern machinery makes it possible for a family to handle a larger acreage than in the past. Doing a good job of operating their own unit is the best reference operators can have when they try to enlarge their operations by renting additional land in the community.

A farm lease is a legal instrument that describes the business agreement between the landlord and tenant. The lease provides the basis for combining the landlord's and the tenant's resources of land, labor, capital, and management to produce farm commodities. The arrangements for sharing farm income and expenses are a very important part of many farm leases. Rental terms need to be revised periodically to keep them up to date. The lease agreement also protects the legal rights of all parties involved.

Common Types of Leases

The three most common types of leases used in Iowa, in order of popularity, are the cash lease, the crop-share lease, and the custom farming contract. The common terms of these leases are described below.

Cash Lease

Under a straight cash lease the tenant pays a given amount of cash rent per acre per year or a lump sum per year for the use of the farm resources. Some cash leases provide for a flexible amount of rent based on actual yields, prices, or both. The landlord may put some restrictions on the number of acres of some crops that can be grown, or what farming practices can be used. Other than this, the tenant has a free rein in planning the crop and livestock production program on the farm unit, and receives all the crop and USDA commodity program payments.

Crop-share Lease

The distinguishing characteristic of a crop-share lease is that the owner receives a share of the crop and USDA payments as a return for the land resources used. In Iowa, a typical division is for the landlord to receive one-half of the grain. The owner's share of a hay crop varies, depending on how the costs for establishing the seeding were shared. In some cases the tenant pays a cash rent for land in pasture or hay. There may be a separate rental charge for a good set of buildings or grain storage facilities.

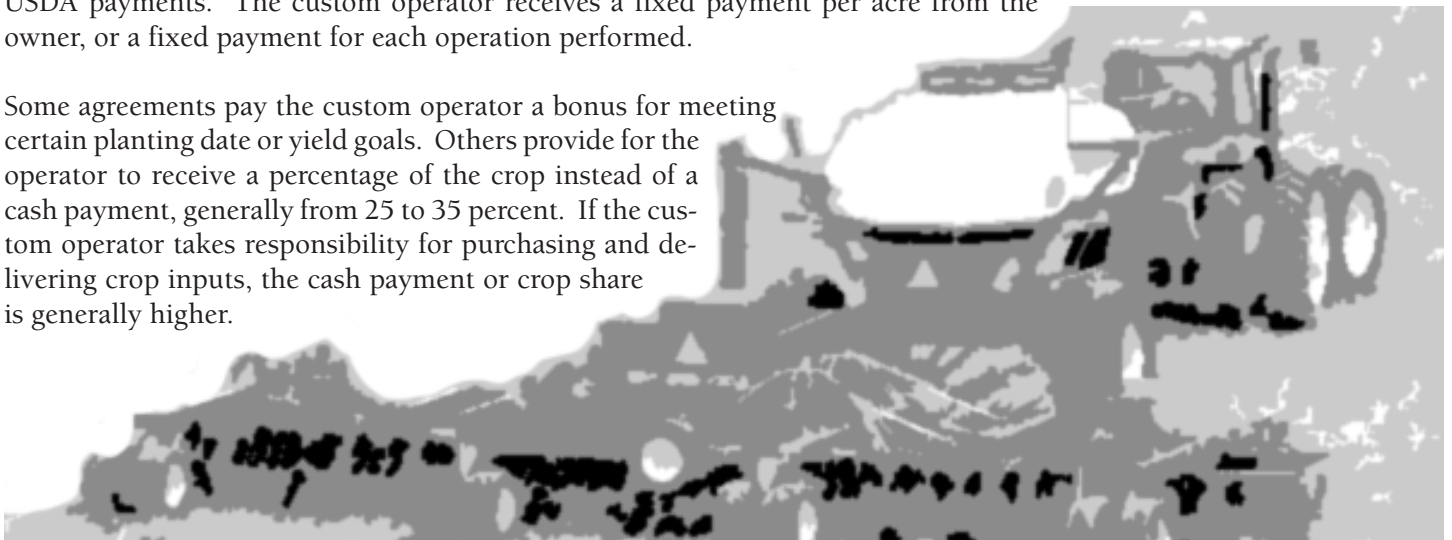
The owner normally furnishes land and buildings and a share of the costs of certain expenses such as fertilizer, seed, and pesticides when the crop is divided 50-50. The tenant usually furnishes all the labor, fuel, equipment, and certain other expenses involved in the crop production part of the farm business. Iowa State University Extension publication FM 1811, *Survey of Iowa Farm Leasing Practices*, provide more details about the sharing of expenses under a crop-share lease.

Some share leases include livestock production, as well. The common terms in a livestock-share lease are that the owner furnishes the land and buildings, and the tenant furnishes the labor and most of the movable equipment. The livestock is owned jointly and receipts from livestock and crop sales are divided as determined in the leasing agreement, usually half and half. Certain operating expenses are also often shared equally, such as feed purchased for livestock, livestock purchases, veterinary bills, and other livestock expenses.

Custom Farming Contract

Under a custom farming contract the operator supplies all the labor and equipment needed to perform tillage, planting, pest control, harvesting, and storing of crops. The landowner pays all other expenses, and receives all the crop and USDA payments. The custom operator receives a fixed payment per acre from the owner, or a fixed payment for each operation performed.

Some agreements pay the custom operator a bonus for meeting certain planting date or yield goals. Others provide for the operator to receive a percentage of the crop instead of a cash payment, generally from 25 to 35 percent. If the custom operator takes responsibility for purchasing and delivering crop inputs, the cash payment or crop share is generally higher.



Advantages and Disadvantages of Different Types of Leases

All types of leases have advantages and disadvantages. The parties entering into a leasing arrangement should recognize these characteristics and consider them in determining the type of lease desired and the terms that should be incorporated in the lease

Cash Lease

Advantages of a straight cash lease are:

- The lease is simple with relatively few chances for misunderstanding.
- The owner is relieved of making day-to-day operating decisions.
- The owner has very little financial risk.
- The tenant has maximum freedom in planning and developing the cropping and livestock programs.
- The tenant has fewer records to keep.

Disadvantages and potential problems of the straight cash lease are:

- A fair cash rental rate may have to be renegotiated each year.
- Cash rents are likely to be too low in times of rising prices and increasing yields, and too high in times of low prices or low yields.
- Tenants are required to supply more operating capital.
- Tenants bear all the risk of price and yield variability.

Crop-share Lease

The advantages of a crop-share lease are:

- Crop risks associated with price and yield variations are shared equally.
- The owner is more involved in operating decisions and marketing the grain during the year.
- Both parties share the benefits from adoption of yield-increasing technology, or unexpected high yields or prices.
- A second USDA payment limit is created.

Disadvantages or potential problem areas of a crop-share lease include:

- The landlord and tenant must determine how production expenses are shared.
- Adjustments for sharing costs for storage and drying facilities, herbicides that reduce field work, or fertilizer and pesticide application may have to be made.
- The cropping plan to be followed and whether or not the farm participates in government programs must be agreed on.

- Added cash rent for buildings and facilities may have to be negotiated.
- If the owner's and tenant's grain is stored in a common bin, marketing decisions have to be made jointly.
- The landowner may be considered a material participant, and farm income will be subject to self employment taxation.

Custom Farming Contract

Advantages of a custom farming contract are:

- There is very little financial risk for the operator.
- The owner benefits from any unexpected high prices, yields or government program payments.
- Only one party is responsible for marketing grain.
- Agreements are usually fairly simple to negotiate.

Disadvantages and potential problems of custom farming contracts are:

- The number and timing of field operations to be done each year may have to be modified, depending on weather conditions.
- The operator may have to set priorities among the custom farmed land and other rented or owned land.
- The owner and the custom operator must agree on the cropping system, fertility program, and type of pest control to be used.
- Crop inputs such as seed, fertilizer and pesticides must be purchased and delivered in a timely manner.
- The landowner may be considered a material participant, and farm income will be subject to self employment taxation.



Factors that Influence Leasing Terms

Many factors influence the terms of an individual farm lease. Some of the main ones are listed below.

- *Productivity of the land.* Historical yields, corn suitability rating (CSR) index, and soil maps can be used to evaluate the relative productivity of each farm or field.
- The value of the *contributions* made by each party in the leasing arrangement, such as labor, capital, or management.
- The *bargaining position* and bargaining ability of each party, and the *competition* for rented land in the immediate area.
- *Custom.* What has been customary in the community in the past is a good starting point, but may not be the best guide because of changing conditions.
- *Family considerations.* A parent-child agreement may be highly favorable to the child when compared with other leases, because the parents do not need as much income, want to help the child get started, and desire to keep the farm in the family.
- *Improvements* and facilities on the farm, dwellings, roads, schools, churches, markets, location, and the size of the farm unit.
- *USDA farm programs.* The crop acreage bases and proven yields assigned to a particular farm will affect the size of some commodity program payments that are paid to the operator.
- *Contracts.* Agreements for producing seed or other specialty crops, or to receive livestock nutrients can enhance the value of a particular property.

Key Areas of Decision Making

There are certain areas in developing a farm lease that should be given very careful consideration by both parties. The answers to these questions will depend on the intent of the parties in the leasing arrangement and the bargaining position of each. Several key areas should be considered.

Cost Sharing

A question that frequently comes up is the landlord's responsibility in sharing herbicide costs for weed control that may be a partial or complete substitute for cultivation or other tillage methods. Most landlords agree to furnish half of the cost of these materials under the crop-share or livestock-share lease. Some feel that where minimum tillage is practiced, they should not have to share in the full cost of herbicides.

One arrangement is for the landlord to share half of the cost of a row or band application of these herbicides, which hopefully will provide better weed control and higher potential yields. This does not reduce the tenant's responsibility for cultivating since weeds will be controlled only in the area over the row. If the tenant wishes to use herbicide over the entire area, he or she pays all of the costs in excess of a share of the banding operation.

There are many variations in the distribution of custom application costs for the inputs mentioned above. Therefore, it is advisable to discuss these items in advance and state in the lease whether or not the landlord will share in any of these costs.



Harvesting

How will costs associated with combining, drying, and storing crops be shared under a share lease? When the corn drying facilities are part of the storage unit, the landlord often furnishes the dryer and storage facilities. If the corn drying unit is portable it may be jointly owned, or either party may own it and charge the other party an established amount for its use. The fuel and power costs for drying are normally shared in the same proportion as the crop is divided. In some leases the tenant is paid extra for delivering the owner's share of the crop from farm storage to an elevator.

Additional Land

What considerations are needed if the tenant proposes to rent additional land from multiple owners? It is advisable that the parties concerned have an understanding about areas such as timing of field operations on each farm, buildings furnished on each unit, commingling of grain, and the records needed by the tenant to assure accurate expense and production accounting to each owner.

Financing Improvements

There are several ways to handle the cost of making permanent improvements, such as buildings, storage structures, conservation structures, fences, waterways, and others.

1. The landlord provides the improvement as part of the rental agreement with an understanding that the rental rate will be increased as a result of the improvements.
2. Cost of the improvements is shared by the landlord and tenant in some form. If the improvement is constructed on the farm, the tenant may furnish labor and machinery for the job.
3. The tenant provides the agreed upon facilities with a provision for being reimbursed by the landlord for the unused portion of the facilities if the lease ends before the useful life of the improvement is expended.

In determining whether or not a lease is fair and equitable to both parties, it is necessary to consider the lease in total rather than individual provisions or sections of the lease. One provision in the lease may be favorable to one party, while another provision may be more favorable to the other party and the two factors may balance out.

Economic and Legal Considerations

There are both economic and legal factors to consider when developing a farm lease agreement. Some of the key economic questions are:

- Does the lease provide the business framework for the most profitable long-term operation of the farm?
- Does the agreement encourage the use of the most profitable levels of capital, labor, and management in the farm business?
- Are the returns shared between the landlord and tenant in an equitable manner when the value of contributions of each party is considered?
- Is the most profitable level of modern technology utilized in the crop and livestock production in the farm business?
- Is the farming unit large enough to achieve an efficient level of operation and provide a satisfactory return to both landlord and tenant? It is much easier to divide a good income fairly than an inadequate income.

Legal considerations in the farm lease also promote an efficient business. Some of the key legal considerations are:

- Does the lease provide adequate legal protection to both parties?
- Is the lease in writing? Written leases leave less chance for disagreement or misunderstanding between the parties over a period of time.
- Is the landowner considered a “material participant?”

Self-employment income

A materially participating landowner must report farm income as self-employment income rather than as passive investment income. As such, it is subject to the normal self-employment tax rate. Of course, paying some self-employment tax will boost social security benefits in the future.

Social security benefits

Landowners under age 65 may have their social security benefits reduced if they are actively involved, depending on the amount and timing of the income received. When landowners reach age 65 and beyond there is no limit on the amount of active income that can be earned with respect to social security benefits.

Estate tax valuation

Many farm properties can qualify for “special-use valuation” when they go through probate, which often results in a valuation below fair market value. This can be advantageous for estates large enough to trigger estate taxes. However, one requirement for special-use valuation is that the decedent, or a family member, must have materially participated in the business five out of eight years prior to death, and a qualified heir must materially participate for ten years after the death of the decedent.

Landlord’s liens

In Iowa, a statutory (created by state law) landlord’s lien exists. The lien is applicable whether the lease is for cash rent or crop share. The statutory lien is a lien “upon all crops grown upon the leased premises, and upon all other personal

property of the tenant which has been used or kept thereon during the term and which is not exempt from execution.” The landlord’s lien must be filed with the Iowa Secretary of State’s office within 20 days of when the lease goes into effect, but remains in force until a different tenant takes over the farm.

Communication

Good communication between tenants and landowners is essential for building a successful leasing relationship. Landowners are concerned about the use and care of their farm. Nonresident owners cannot observe conditions first hand. Widows may not have been heavily involved in the management of the property, and feel unsure about how to proceed with decisions.

Provide Reports

Tenants can borrow a technique from professional farm managers who provide their clients with written reports on a regular basis. Obviously, a report is more important with a crop share or livestock share lease than a cash lease. But it may be beneficial for a tenant with a cash lease to develop an abbreviated form of reporting, especially for landowners who have a strong interest in the productivity of the farm.

Sending pictures to a landowner who is not close enough to observe crop conditions each year is a very effective communication tool. Today, digital camera photo files can be easily transmitted by e-mail.

For a crop share lease, keep the accounting of expenses current. Most input suppliers will invoice each party individually. However, inform the owner beforehand that he/she will be receiving a bill and what it is for. Tenants renting from several owners may purchase supplies in volume and prorate the bill to each of the owners. In this situation a copy of the original invoice should be included. Explain each item on the bill. Names of farm inputs change frequently. The owner may not be familiar with commercial product terms for seed, herbicides and insecticides, but nonetheless may have to categorize the expenses for income tax reporting.

Why have a written lease?

A written lease is like the minutes of a meeting. It tells when you met, who was there, and what was decided. Written leases make the lease terms more definite and leave less chance for disagreement and misunderstanding. People tend to selectively recall only those portions of conversations that reinforce their point of view. It protects not only the original parties, but also assignees and heirs in case either party should die, or the farm is sold.

A written lease encourages both parties to consider many phases of the lease before the lease period begins. Decisions are made before the problems occur. In subsequent years, it provides a basis for changing lease provisions when adjustments are desirable, as well as documentation in case of an Internal Revenue Service audit.

The document should meet at least the following minimum requirements:

- Both parties should properly sign it.
- It should specify a definite period for which the lease is to run.
- It should contain an accurate description of the property.
- It should state the kind and amount of rent and time and place of payment.

Termination of a Farm Lease

A farm lease automatically continues from year to year unless either party gives a notice of termination. In Iowa, a lease termination notice must be properly served by September 1, prior to the end of the lease year. The termination notice must fix the termination of the tenancy to take place on the following March 1. If notice is not served, the lease continues for another crop year under the same conditions and terms. However, if mutually acceptable to all parties concerned, a lease can be terminated or modified at any time.

Iowa law specifies three methods of serving a farm lease termination notice to terminate the tenancy on the following March 1. The following is quoted from the Code of Iowa, Section 562.7:

“Notice—How and when served. Written notice shall be served upon either party or a successor of the party by using one of the following methods:

1. By delivery of the notice, on or before September 1, with acceptance of service to be signed by the party to the lease or a successor of the party, receiving the notice.
2. By serving the notice, on or before September 1, personally, or if personal service has been tried and cannot be achieved, by publication, on the same conditions, and in the same manner as is provided for the service of original notices, except that when the notice is served by publication no affidavit is required. Service by publication is completed on the day of the last publication.
3. By mailing the notice before September 1 by certified mail. Notice served by certified mail is made and completed when the notice is enclosed in a sealed envelope, with the proper postage on the envelope, addressed to the party or a successor of the party at the last known mailing address and deposited in a mail receptacle provided by the United States postal service.”

A form entitled “Notice of Termination of Farm Tenancy” prepared by the Iowa State Bar Association is available from law offices.

The individual lease may state a date earlier than September 1 for serving a termination notice. The requirement to terminate a farm lease applies only to cropland in tracts of 40 acres or more. It does not apply to pasture land rented separately or tracts under 40 acres in size. Only a 30-day notice is required in these cases.

Oral leases are valid in most states. In Iowa they cannot have a life of more than one year. Nevertheless, even an oral lease is automatically renewed if it is not properly terminated in time.

Summary

A good lease is the first step toward a satisfactory operating relationship between a landlord and tenant. Although it is probably impossible to develop a lease that will provide for all possible situations that might arise, the parties should try to anticipate the potential areas where problems may arise and plan provisions in the lease to handle them. Only the parties involved can determine what is fair to each and what the final agreement should be. Since many factors influence a leasing agreement, each contract should be modified to fit the individual situation.

Additional References

From Midwest Plan Service

- NCR 75 *Fixed and Flexible Cash Rental Arrangements for Your Farm*
- NCR 76 *Cash Farm Lease with Flexible Provisions (form)*
- NCR 105 *Crop-share or Crop-share/Cash Rental Arrangements for Your Farm*
- NCR 77 *Crop-share or Crop-share/Cash Farm Lease (form)*
- NCR 148 *Irrigation Crop-share and Cash Rental Arrangements for Your Farm*
- NCR 106 *Irrigation Crop-share or Crop-share/Cash Farm Lease (form)*
- NCR 149 *Pasture Rental Arrangements for Your Farm*
- NCR 109 *Pasture Lease (form)*
- NCR 214 *Rental Agreements for Farm Buildings and Livestock Facilities*
- NCR 215 *Farm Buildings and Livestock Facilities Lease (form)*

Available at www.mwpsdq.org or call (800) 562-3618.

From Iowa State University Extension

- FM 1538 *Iowa Farm Lease (form)*
- FM 1724 *Flexible Farm Lease Agreements*
- FM 1728 *Iowa Farmland Rental Rates*
- FM 1801 *Estimating Cash Rental Rates for Farmland*
- FM 1811 *Survey of Iowa Farm Leasing Practices*
- FM 1823 *Custom Farming: an Alternative to Leasing*
- FM 1825 *Iowa Farmland Value Survey*
- FM 1851 *Cash Rental Rates for Iowa (survey)*

Available at www.extension.iastate.edu/pubs/ or call (515) 294-5247.

- *Farm Leasing Arrangements* (home study course on the Internet) Available at: www.extension.iastate.edu/ames/



Revised by William Edwards, extension economist. Originally prepared by E.G. Stoneberg, former extension economist. Designed by Kathy Summy, extension communications.

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